No. 15,291

IN THE

United States Court of Appeals

For the Ninth Circuit

UNITED STATES OF AMERICA,
Appellant,

vs.

MERVIN L. GARDNER and MYRTLE G. GARDNER, his wife,
Appellees.

On Appeal from the Judgment of the United States District Court for the District of Nevada.

BRIEF FOR APPELLEES.

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BRIEF FOR APPELLEES.

INTRODUCTION.

Appellees will accept appellant's statement of the case with the exception that on pages 7 to 10 of its brief, in stating the material parts of the taxpayer's affidavit in support of his motion for summary judgment, appellant omitted reference to paragraph 6(i) of the affidavit which reads:

> "That during the latter part of 1951 and up to September 16, 1952, said corporation was operating on borrowed capital, had assigned the proceeds of its jobs to its lenders as security for said loans, and all through said period of time was on the narrow edge of bankruptcy." (R. 22, para. i.)

Appellant lists quite a few points to be urged (Appellant's Brief pp. 12-14), but reduces these to two points of argument. Appellees will answer each point separately and state the points as follows:

STATEMENT OF POINTS TO BE URGED.

1. No material issues of fact were in controversy.

2. Appellee Gardner did not wilfully fail to collect and pay the withholding and F.I.C.A. taxes.

SUMMARY OF ARGUMENT.

Appellees' motion for summary judgment was properly granted.

No issues of fact existed. The opposing affidavit of Mr. Forrester was hearsay and was not based on personal knowledge so could not be considered by the court—but, even if considered, it raised no issue as to the ability of the corporation to pay the taxes when due. It is undisputed that at the time the tax payments were due the corporation had no funds to pay the taxes and was insolvent. At the time the last tax payment was due, the corporation was in receivership and appellees no longer had any control over corporate affairs.

I.

NO MATERIAL ISSUES OF FACT WERE IN CONTROVERSY.

Appellant's position is that the affidavit of Homer H. Forrester (R. 26-28) contradicted the taxpayer's affidavit.

It is appellees' firm belief that Mr. Forrester's affidavit presented no basis for denying appellees' motion for summary judgment.

Appellees will here discuss each paragraph of Mr. Forrester's affidavit as it related to appellees' motion for summary judgment. However, before so proceeding, it might be well to quote the rule from the Federal Rules of Civil Procedure which governs the form of affidavits to be used in supporting or opposing motions for summary judgment. The rule is as follows:

> "Supporting and opposing affidavits shall be made on personal knowledge, shall set forth such facts as would be admissible in evidence, and shall show affirmatively that the affiant is competent to testify to the matters stated therein. Sworn or certified copies of all papers or parts thereof referred to in an affidavit shall be attached thereto or served therewith. The court may permit affidavits to be supplemented or opposed by depositions or by further affidavits."
>
> Rule 56(e), *Federal Rules of Civil Procedure.*

Paragraphs 1, 2 and 3 of Mr. Forrester's affidavit (R. 26) are rather general and apparently designed to demonstrate his competency to make the affidavit.

> "1. That he is the Chief of the Delinquent Accounts and Returns Branch, and as such has custody of the pertinent files and records in the office of the District Director of Internal Revenue, Reno, Nevada.
>
> 2. That he had personally examined and is familiar with these records and has supervised the

> investigation into the affairs of the Gardner Supply Company, Inc. and Mervin L. Gardner, their records and the records of third parties having business transactions with them.
>
> 3. That on the basis of his personal knowledge and on the records of the office of the District Director made in the regular course of its investigations into the liabilities herein, affiant states that:" (R. 26).

The allegations contained in the paragraphs, however, cast considerable doubt on such competency as each paragraph refers to "records" as well as personal knowledge. We do not know which part of the affidavit is based on records and which on personal knowledge. The objection thus arises that, if the affidavit is based on written records, certified copies of such records should have been attached to the affidavit as required by Rule 56(e) of the Federal Rules of Civil Procedure:

> " . . . Sworn or certified copies of all papers or parts thereof referred to in an affidavit shall be attached thereto or served therewith. . . . "
>
> Rule 56(e), *Federal Rules of Civil Procedure.*

Furthermore, Rule 56(e) requires that the affiant set forth matters as to which he would be competent to testify. Mr. Forrester would not be competent to testify to the records of Gardner Supply Co., Inc., of the appellees or of the District Director of Internal Revenue, much less the records of third parties referred to in Paragraph 2 of the affidavit. The records

themselves are the only competent evidence of their contents—hence the requirement of Rule 56(e) that certified copies of all papers referred to in the affidavit shall be attached to the affidavit. It would thus seem that the entire affidavit is faulty because based, to some unknown extent, on written documents and not on personal knowledge.

Nevertheless, let us examine the remainder of the affidavit for we will find that, even if we consider the material set forth, no basis was made for denying the motion for summary judgment. The next paragraph reads:

> "3.(a) Mervin L. Gardner was in complete control of all phases of the operations of the Gardner Supply Company, Inc. during the times covered by the assessments herein and had full knowledge of the financial and tax affairs of the Gardner Supply Company, Inc." (R. 26.)

Paragraph 3(a) is an extremely general statement, not of facts but of an opinion, of a conclusion. Even if it be accepted as stating facts, it would not have warranted denial of the motion in view of the uncontradicted facts set forth in appellees' affidavit.

Paragraph 3(b) states:

> "3.(b) That Mervin L. Gardner was personally contacted by the office of the District Director on numerous occasions during the period the liability herein arose with repeated demands for payment by the Gardner Supply Company, Inc. of its taxes and he admitted knowledge of the corporation's liabilities." (R. 26-27.)

Who in the office made the demands? This is not a statement made on personal knowledge as required by Rule 56(e) of the Federal Rules of Civil Procedure. The person who made the demand should have made an affidavit to that effect.

Paragraphs 3(c) and 3(d) of Mr. Forrester's affidavit are along the same general line as Paragraph 3(a), that is, "that appellee Mervin Gardner knew the corporation had not paid the withholding taxes and continued to employ labor on behalf of the corporation without paying the withholding taxes that had been or should have been withheld from the labor payments." (R. 27-3(c).) The quoted portion indicates that Mr. Forrester does not know whether the taxes were actually withheld or not. This seems odd in view of the statement in Paragraph 3(e) of the affidavit that the money withheld was diverted to other uses.

> "3.(e) The money withheld was used and diverted to pay other expenses of the Gardner Supply Company, Inc. and Mervin L. Gardner individually." (R. 27.)

If Mr. Forrester does not know whether the money was withheld or not, how can he know whether or not it was diverted to other uses? This clearly demonstrates that the affidavit is not based on solid facts, but is based on supposition. Furthermore, Mr. Forrester's statement that Gardner knew the corporation was not paying its taxes is apparently based on the prior statement that a demand was made upon Gardner for the taxes. But we have seen that such

statement was not made on personal knowledge. The conclusion that Gardner had such knowledge is also thus not made on personal knowledge.

Paragraph 3(f) is a statement of position and not of fact and cannot be considered as evidence, except as to the statement of assessments made.

> "3.(f) The assessments herein were properly made and any monies collected thereon properly collected. These assessments were made on or about July 1, 1953, and the total amount of the assessments was $38,781.63 plus statutory additions." (R. 27-28.)

Paragraph 3(g) cannot be considered at all.

> "3.(g) Without admitting any of the other allegations in the affidavit, he denies knowledge of the self-serving allegations in paragraph 6 of the plaintiffs' Affidavit, and denies particularly the allegations in paragraphs 6c, d and e, and paragraphs 7 and 8 thereof." (R. 28.)

The very use of such language indicates the complete lack of evidence to support the Government's position. Mere denials have no place in an affidavit opposing a motion for summary judgment.

> "Mere formal denials or general allegations which do not show facts in detail cannot defeat summary judgment. McClellan v. Montana-Dakota Utilities Co., 109 F. Supp. 46, Aff'd. 204 F. 2d 166. . . . Where defendant's motion for summary judgment in civil right proceeding was supported by proper affidavits and plaintiffs' counter-affidavit was devoid of any factual matter, the motion would be granted. Morgan v.

> Sylvester, 125 F. Supp. 380. . . . One cannot reserve his evidence when faced with motion for summary judgment by mere formal denials or general allegations which do not show the facts in detail or with precision. Appolonio v. Baxter, 217 F. 2d 267."
>
> 10 *Cyclopedia of Federal Procedure, 1955 Cumulative Supplement* 29-30.

Since the affidavit of Mr. Forrester is not made on personal knowledge, does not show that Mr. Forrester is competent to testify to the matters stated in the affidavit, and does not have attached sworn or certified copies of the records referred to in the affidavit, all as required by Rule 56(e) of the Federal Rules of Civil Procedure, the affidavit is no affidavit at all and is not entitled to any consideration.

It is also interesting to note that Mr. Forrester's affidavit does not even refer to the insolvency of the corporation; or does the affidavit—or appellant's brief herein—attempt to explain why appellee Mervin Gardner was penalized, among other things, for failure to see that the corporation paid the third quarter 1952 taxes when it is undisputed that at the time such taxes were payable the corporation was in receivership and Gardner no longer had any control over corporate affairs? (R. 23, Para. M.)

II.

APPELLEE GARDNER DID NOT WILFULLY FAIL TO COLLECT AND PAY THE CORPORATE WITHHOLDING AND F.I.C.A. TAXES.

Before presenting their argument on this point, the appellees will first briefly review the decided cases which have involved the penalties in question.

Paddock v. Simoneit, 218 S.W.2d 428 (Supreme Court of Texas, 1949):

In this case, the U. S. Government sued the managing officer of a corporation for the civil penalty assessed for wilful failure to pay withholding tax. The court held the officer liable for the penalty with the following facts appearing:

a. Officer was the disbursing officer of the corporation.

b. Officer knew the taxes were due and knowingly and intentionally decided not to pay the taxes.

c. Court found no proof that the corporation could not have paid the taxes when due.

d. Officer was indebted to the corporation in the amount of $30,510.63 for advances made to him by the corporation.

Comment: It will be noted that as to each of the above factual elements, the reverse of such facts exists in the present case. The corporation had no funds to pay the taxes when due and the corporation was indebted to appellees in the sum of $6,814.30 (R. 24, Para. 8) at the time it went into receivership.

In Re Haynes, 88 Fed. Suppl. 379 (U. S. District Court, Kansas, 1948):

The government filed a claim against the bankrupt's estate for the one hundred percent (100%) penalty for failure, as President of the corporation, to pay withholding and F.I.C.A. taxes. The court held the penalty applicable and said:

> "It is in our judgment that as the word 'wilful' is used in this statute, it does not mean wicked design but rather that the person acts knowingly and intentionally. It would seem therefore that if the officer of the corporation had in his hands or under his control the funds that had been set apart for the purpose of paying the tax and appropriated such funds to some other purpose that he acts 'wilfully'."
>
> *In Re Haynes,* 88 Fed. Suppl. 379.

The following pertinent facts appeared in the case:

a. No showing that the corporation did or did not have sufficient funds to pay the taxes.

b. Court presumed that if corporation paid workers' wages that it had funds to pay withholding taxes, the evidence being indefinite on this point.

Comment: Court went on presumption that the corporation had funds to pay the taxes and used funds for some other purpose. In the present case, the affidavit of Gardner clearly shows that the corporation had no funds with which to pay withholding. The corporation was practicing deficit financing and could have paid withholding only if it had borrowed more

money. Can Gardner be guilty of "wilfully" failing to pay when the corporation would have had to borrow money to pay?

Kellems v. U. S., 97 Fed. Suppl. 681 (U. S. District Court, Conn., 1951):

This was the rather well-known case where Vivien Kellems refused to pay withholding, contending the law providing for such was unconstitutional. The court held her liable for the one hundred percent (100%) penalty, holding that she had no reasonable ground upon which to base her belief that the statute was unconstitutional. The court had occasion to say "that the word wilful in the penalty statute means 'without reasonable cause', that is to say 'capricious'."

Comment: It cannot be seriously contended here that appellees' failure to see that the taxes were paid was "capricious."

Wade v. U. S., 54-2 U.S.T.C. 47-145 (U. S. District Court, W. Va., 1954):

This opinion is not very helpful as it consists only of the formal findings of fact and conclusions of law. The facts of the case are not disclosed in the opinion, but the court held the officer of the corporation not liable for the 100% penalty and found him entitled to recover from the United States the penalty collected. The following note was appended to the opinion by C.C.H., the publishers of the volume:

"The record of the case discloses that the complainant was the president of the employing cor-

poration, but had been given one share of stock to qualify as such and had been made president at the instance of a large lien creditor to supervise the affairs of the company for the protection of the creditor and of all other creditors. The treasurer of the company (not involved in this case) was charged with the duty of preparing, and did prepare, the withholding returns—C.C.H."

Comment: In the present case the auditor and the bookkeper, not Gardner, were given the duty of preparing the tax reports and of making and signing the checks to pay the taxes due.

Levy v. United States, 140 Fed. Suppl. 834 (U. S. District Court, W. D. Louisiana, 1956):

This opinion also is in the form of findings of fact and conclusions of law.

The facts as found by the court were that taxpayer was the manager of the corporation and his duties included collection and payment of social security and withholding taxes. Because of the poor condition of the corporation, the taxpayer personally paid $2,000.00 of corporate taxes in an effort to keep the business going. After this payment an apparent employee of the corporation was instructed to deposit all such taxes in a special fund and to pay such taxes promptly. The employee failed to do this and taxpayer did not discover such until a time in late 1952 or early 1953 when the corporation had no funds with which to pay the full amounts due. The taxes due were for the last quarter of 1952 and the first quarter of 1953. On March 11, 1953, a pre-existing mortgage

was foreclosed putting the corporation out of business and leaving it without funds to pay the taxes.

The court concluded:

> "Here, since plaintiff did not know that the taxes in question were past due and unpaid, until shortly before the corporation failed completely, and at a time when it could not pay, he could not have 'wilfully' failed to collect, pay, or truthfully account for them within the meaning of the section involved. Mere negligence, in failing to ascertain facts, is not enough to render him liable for the penalty."

Levy v. United States, 140 Fed. Suppl. 834.

Comment: The case is almost on all fours with the present case. In the cited case, as in the present case, the taxpayer loaned money to the corporation to pay earlier taxes. In the cited case, the business was stopped by a mortgage foreclosure; in the present case the business was stopped by being placed in receivership. In the cited case, as in the present case, the corporations were practicing deficit financing and did not have the funds with which to pay the taxes.

Nugent v. United States, 136 Fed. Suppl. 875 (U. S. District Court, N. D. Illinois, 1955).

In this case the taxpayer claimed that failure to pay social security taxes was not wilful because:

(1) At the time the taxes were due the State of Wisconsin was engaged in litigation concerning the applicabilty of the taxes to the corporation, and

(2) That the corporation became insolvent prior to the termination of the litigation.

As to the first point, the court noted that had the corporation prior to filing the Social Security Return paid the State of Wisconsin instead of the United States and the litigation determined that payment should have been to the United States, the law allowed the corporation to take a credit in the amount paid the state against the tax due the United States. The corporation did not do this nor did the taxpayer even claim that the Social Security Tax was not applicable to the corporation.

On the second point, there was no evidence to show that the corporation was insolvent at the time the tax was due (only at the time of the termination of the litigation) and no such contention was urged by the taxpayer.

Comment: In the present case the undisputed facts show that the corporation was insolvent when the taxes were due—indeed, when the last tax payment was due the corporation was in receivership.

Let us now examine the present case in the light of the above-cited cases.

The corporation was first on the verge of not paying withholding and F.I.C.A. taxes in the third quarter of 1951. Appellee Mervin Gardner personally prevented such by borrowing sufficient funds on his life insurance to pay the taxes (R. 21, Para. f). Had the corporation had the money to pay such taxes, Gardner certainly would not have borrowed on his life insurance. Since the corporation's financial condition became worse, not better, in the following quar-

ters, it must be clear that the corporation did not have funds to pay the taxes.

As to this, however, the appellant argues:

> "However, the fact that the taxpayer was making an effort to prevent his business from failing does not excuse him from his failure to pay over the withholding and employment taxes which he had collected from his employees." (Appellant's Brief, page 23.)

The fault with this argument, which is the heart of appellant's case, is that it assumes that money was actually withheld—that there was some fund—fleeting though its existence might have been, which the corporation could identify as money withheld from wages. Such an assumption is not supported by the facts—uncontradicted facts—which clearly show that the corporation was deeply in debt and operating at a loss. The money paid to employees was not corporate money but borrowed money. Are the corporate officers guilty of wilful failure to pay withholding and F.I.C.A. taxes by failing to borrow additional sums to pay the taxes?

However, from the appellant's insistence that the money was collected, we may assume that the penalties were levied for failure to "pay" and not for failure to "collect." Appellant can hardly argue that appellees failed to collect the taxes since it is admitted by all that the wages paid employees were reduced in the proper amount for withholding and F.I.C.A. taxes.

As is done in most businesses, the taxes due were no doubt set up on the corporate books as payable, a correct accounting made and report filed. (R. 21, Para. d.) The corporation did not pay the money when due simply because it did not have the funds. The taxes are payable on the last day of the month following the quarter in which the taxes accrued (1952 Income Tax Regulations, Sec. 405.601). It is uncontradicted that at the end of each such month that, not only was the corporation in debt on demand notes in excess of $200,000.00 (R. 23, Para. o), but corporate checks written exceeded money in the bank by $2,382.34 to $7,673.27. (R. 22, Para. j, k, l.) Under such facts the corporation could not have paid the taxes. Appellees certainly cannot be found guilty of wilfully doing something which it was impossible to do.

That the question of solvency is important in this type of case is clearly shown by the consideration given the point by other cases.

In *Paddock v. Simoneit,* 218 S. W. 2d 428 (referred to at page 23 of appellant's brief with the remark that it involved "a factual situation remarkably similar to that at bar") the court found, in holding the penalty applicable, that there was no proof that the corporation could not have paid the taxes when due. The court said at page 583—"Nor does the proof show that the corporation could not have paid the taxes when they were due."

The court in the case of *In Re Haynes,* 88 Fed. Suppl. 379, referred to on page 27 of appellant's

brief, held the penalty applicable but presumed the corporation had the funds to pay the taxes because (page 383):

> "The evidence is indefinite as to whether the corporation had in its possession and under its control the Withholding Taxes. . . ."

The evidence is *not* indefinite in the present case and no such presumption can be made.

In *Levy v. United States,* 140 Fed. Suppl. 834, the court found that the corporation was without funds to pay the taxes and held the penalty not applicable.

In *Nugent v. United States,* 136 Fed. Suppl. 875, the court found that there was no evidence to show that the corporation was insolvent at the time the tax was due and held the penalty applicable.

In *Kellems v. United States,* 97 Fed. Suppl. 681, the solvency of the corporation was apparent and the penalty applied, while in *Wade v. United States,* 54-2 U.S.T.C. 47-145, the penalty was held inapplicable on other grounds.

We thus find that all of the courts which had occasion to comment on solvency of the corporation held the penalty applicable because of the failure to prove insolvency—and in the one case (*Levy v. United States,* 140 Fed. Suppl. 834), where insolvency was proven, the court held the penalty not applicable. The existence of ability to pay certainly appears to be a *sine qua non* to wilful failure to pay.

The appellant's position apparently is that a man should quit doing business before he gets in debt.

Such might be a salutary rule—however odd in a country built on credit—but it does not meet with the economic facts of life. Appellant seeks to penalize appellees one hundred percent for being connected with a corporation which went broke while indebted to the government. It would be an odd law in this free enterprise country of ours which would penalize a man one hundred percent for trying to make a business a success—and failing.

CONCLUSION.

The judgment of the Lower Court is correct on two separate grounds—

1. Appellees did not have knowledge of the failure of the corporation to pay the taxes.

2. Even if we assume appellees had such knowledge, it is undisputed that the corporation did not have the funds to pay the taxes when due and was insolvent.

Dated, Reno, Nevada,
March 18, 1957.

Respectfully submitted,
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